No. 5981.

IN THE

United States

Circuit Court of Appeals,

FOR THE NINTH CIRCUIT.

In the Matter of
GILBERT S. GORDON,
Bankrupt.

India Tire & Rubber Company,
Appellant,
vs.
Carl O. Retsloff, Trustee in Bankruptcy of Gilbert S. Gordon, Bankrupt,
Appellee.

APPELLANT'S BRIEF AND ARGUMENT ON APPEAL.

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APPELLANT'S BRIEF AND ARGUMENT ON APPEAL.

STATEMENT OF FACTS.

Gilbert Gordon was adjudicated a bankrupt on the 18th day of June, 1928, and Carl O. Retsloff duly appointed trustee. A claim against the estate of said bankrupt in the sum of $9,038.54 was filed by appellant. This claim was disallowed on the ground that the appellant had received a preference. The objection and order sustaining the objection to said claim appear at pages 5 and 6 of the transcript of record herein.

At the hearing had before the Referee upon the trustee's objections to appellant's claim, the testimony was reduced to writing, and upon the Referee's order sustaining the objections to the allowance of said claim, appellant demanded a review by the District Court and upon the same testimony the District Court made an order affirming the decision of the Referee. [Tr. of Rec. pp. 10 and 11.] From the order of the District Court so made this appeal is taken.

The testimony shows that the bankrupt, Gilbert Gordon, was engaged in the business of selling automobile tires at San Diego, California, and had been so engaged for some years prior to 1928 and during all such time had been handling merchandise sold to him by the appellant; that on the 18th day of April, 1928, the appellant caused a quantity of tires, which had been sold to the bankrupt by the appellant, to be reclaimed and returned from the bankrupt's place of business to appellant's warehouse at Los Angeles and credit for the tires so taken was given said bankrupt in the same amount as had been charged for said merchandise when it was sold to the bankrupt a few months previous thereto. It is this transaction of April 18th, 1928, which appellee contends constituted a preference and justified the disallowance of appellant's claim.

ARGUMENT.

In order to justify the decision of the Referee sustaining the objection to the allowance of appellant's claim it must appear:

1st—That the debtor was insolvent at the time of the transaction in question;

2nd—That the appellant had reasonable cause to believe that the transaction would effect a preference.

57-G, 60-B, Bankruptcy Act.

Assignment of Error Number One. [Tr. of Rec. p. 45.]

INSOLVENCY.

There was no competent evidence before the court justifying the finding that the bankrupt was insolvent on April 18th, 1928. Such evidence as there was before the court tended only to prove that the bankrupt was in financial difficulties and was not in all cases paying his bills as they became due. The only direct evidence of insolvency was the testimony of the witness Blodgett, who testified as a conclusion that he believed the bankrupt to be insolvent on the date in question. [Tr. of Rec. pp. 26, 40, 41.] As to the testimony of the witness just referred to, we call attention to the fact that this testimony was objected to and that the witness was permitted to testify as above indicated over objection by appellant; that this testimony was improper is apparent on the face of the record. Insolvency must be proved in the same manner as any other fact. To this effect the rule stated in Remington on Bankruptcy, section 1765, is as follows:

> "In general, the ordinary rules of evidence are to govern in the proof of insolvency."

Opinion evidence is properly received to prove insolvency, but the opinion of the witness must relate to the value of the property and not to the ultimate and precise question before the court for decision. One may as well be permitted to ask a witness in a personal injury case whether in his opinion the defendant was negligent, as to

permit a witness to give an opinion as to whether or not a debtor is solvent when that is the precise issue to be determined. Where assets consist in part of accounts receivable, a witness who has shown himself qualified may give his opinion as to the value of certain or of all the accounts, as was done in Doyle-Kidd Dry Goods Co. v. Trading Co., 206 Fed. 813.

But there is no rule which permits a witness to give an opinion as to whether a person is or is not solvent.

Summary of Evidence Bearing on Solvency.

We summarize all of the evidence in the record bearing upon the question of solvency as follows:

(a) The witness Retsloff testified [Tr. of Rec. pp. 18-19] that Mr. Schwan (who was credit manager of the India Tire & Rubber Co. at the time of the transaction in question but who died prior to the hearing before the Referee) stated to him that he knew that Mr. Gordon "was broke" and that he took the tires out for the reason that he knew Mr. Gordon probably would not get out of bed again as he was very sick at that time. This conversation took place on the 10th day of July, 1928, after the adjudication in bankruptcy.

In the first place it does not appear what Mr. Schwan meant by saying that he knew Mr. Gordon "was broke." That is, it does not appear at what time Mr. Schwan's statement relates to, whether Mr. Schwan meant to say that he knew at the time of the conversation on July 10th that Mr. Gordon was broke or whether he knew at some previous time that Mr. Gordon was broke. If it related to a previous time there is no indication as to what previous

time Mr. Schwan was referring to. Again, it does not appear to any degree of certainty what Mr. Schwan meant by the term "broke" but from the connection in which the word was used it would not appear that Mr. Schwan meant to say that he knew Mr. Gordon was insolvent, for the reason that Mr. Schwan stated in the same conversation that the reason he took the tires away was that he knew "that Mr. Gordon probably would not get out of bed again as he was a very sick man at that time and wanted to get his account in shape." [Tr. of Rec. p. 18.]

Furthermore, the later conduct of Mr. Schwan in his dealings with the bankrupt indicates very definitely that he did not know or believe that Mr. Gordon was insolvent at the time the merchandise was returned. We shall discuss this phase of the situation in connection with our discussion as to whether appellant had reasonable cause to believe a preference would be effected.

(b) The witness Blodgett testified [Tr. of Rec. p. 20] that he told Mr. Schwan that his company (Richfield Oil Company) had put Mr. Gordon on a cash basis. The witness Blodgett further testified that he and Mr. Schwan had a conversation with Mr. and Mrs. Gordon on the 8th day of May, 1928, relative to their financial condition in general. [Tr. of Rec. p. 20.] In that conversation it appears that Mr. Gordon was asked for a financial statement as of that date and that the bankrupt and his wife consented to have Mr. Blodgett and others take an invoice of the stock and that they took such an invoice and made an appraisal of the building and equipment [Tr. of Rec. p. 20] and after that invoice was taken and that appraisal was made, a financial statement was prepared by Mr.

Blodgett with the assistance of Mrs. Gordon and Mr. Schwan, which financial statement appears at pages 34 to 36, transcript of record. This financial statement shows a net worth of $4,748.88. We call attention to the fact that in the statement the item $4,748.88 is referred to as "total liabilities" but it is apparent that this item is intended to indicate net worth. The testimony of the witness Blodgett is to that effect. [Tr. of Rec. p. 24.]

We think that this statement, made under the circumstances indicated, has great bearing on the question of whether the proof shows that the bankrupt was insolvent on April 18th, 1928, and whether the appellant had reason to believe that a preference would be effected by reason of the return of the merchandise in question. The witness Blodgett admits that before this statement was made he had a conference with Mr. and Mrs. Gordon and that they discussed their financial affairs. Not satisfied with the discussion and with the information obtained from Mr. and Mrs. Gordon, Mr. Blodgett made an invoice of the stock and an appraisal of the equipment, and with that information in hand, he prepared the statement referred to and that statement showed a net credit balance of over $4,000.00. When Mr. Blodgett transmitted this statement to his company he must have believed that Gordon was solvent. He could not, in fairness to his own company, have transmitted such a statement as this unless he did believe Gordon to be solvent. This is important in two respects:

1st—If Mr. Blodgett, after a personal inspection and appraisement of the property, believed that Gordon was solvent it is but reasonable to suppose that Mr. Schwan

believed the same thing, as the testimony shows that Mr. Schwan had a copy of the appraisement made by Mr. Blodgett, and assisted in making it out. [Tr. of Rec. p. 33.]

2nd—If Mr. Blodgett believed that Gordon was solvent on May 8th, 1928, when this statement was prepared, his testimony to the effect that he believed Gordon to be insolvent at all times after January 1 cannot be true.

(c) The witness Blodgett testified that Gordon gave him a statement in January, 1928, showing a net worth of $17,000.00. [Tr. of Rec. p. 24.]

(d) Testimony of Mr. Blodgett that in his opinion bankrupt was insolvent. [Tr. of Rec. pp. 26, 40 and 41.]

An examination of the testimony of Mr. Blodgett at the pages last referred to indicates to us that the witness was going as far as he could possibly go to give the answers which the Referee evidently desired him to give in the insistent questions put to him and yet at no time does the witness state definitely that he ever told Mr. Schwan that the bankrupt was insolvent, and at no time does he give any facts from which the court was justified in finding that the bankrupt was in fact insolvent.

In his answer appearing on page 41, transcript of record, he gives the fullest account of his reason for thinking that the bankrupt was insolvent. Those reasons were that he had a large amount of stock which was unpaid for; that he had an unreasonable amount of credit on his books that, in the judgment of the witness, was not collectable; that he had included in his statement an item of $6,000 or $7,000 as representing the value of a lease when he had no

lease; that he stated the amount his building was worth was in excess of its worth and that he was unable to meet his obligations when due.

The fact is that in neither financial statement before the court is there any item representing a lease of the value of $6,000 or $7,000, or any sum. There is an item in the statement shown at page 28 [Tr. of Rec.] of $7,000 for an "option on business property." If that is what the witness referred to as a lease it is of no special significance for if that item were eliminated entirely from this statement it would still leave the bankrupt a net worth of over $18,000 according to such statement. Furthermore, neither the item "option on business property" nor the item "building" which appeared in this statement [Tr. of Rec. p. 28] is included in the statement which the witness Blodgett prepared, shown on page 36 [Tr. of Rec.], and in that statement there is a net credit balance of nearly $5,000.

But the most convincing reason for believing that the witness Blodgett was not in good faith in giving his conclusion that the bankrupt was insolvent is found in his statement just referred to, to the effect that the bankrupt had a large amount of credit on his books which was not collectable. In the property statement shown at page 34 of the transcript of record which Mr. Blodgett himself obtained from the bankrupt, there appear two items of accounts receivable aggregating $5,214.03. Mr. Blodgett says that a large amount of these accounts were uncollectable and that this fact led him to believe that the bankrupt was insolvent. Yet, if we eliminate entirely those two items representing accounts receivable, we would find that the bankrupt would lack only $465.15 of being solvent. But it is not reasonable to suppose that the accounts re-

ceivable referred to, which Mr. Blodgett incorporated in a statement made to his own company for the purpose of showing the financial condition of this bankrupt, were entirely worthless, or anywhere near worthless. Mr. Blodgett doesn't claim that these accounts were worthless, but merely claims that he found a large number of them which were, in his judgment, uncollectable. Before his statement that a large number of these accounts was uncollectable is accepted as showing insolvency, he should be required to show what particular accounts they were, his means of knowing their value, and the aggregate amount of the so-called uncollectable items.

It thus appears that not one substantial reason was given by the witness to justify his conclusion that the bankrupt was insolvent.

(e) Report and statement of Bradstreet Company. [Tr. of Rec. p. 28.]

This report was based upon information gathered in November, 1926. This report was made on March 21, 1928, but the report states [Tr. of Rec. p. 29] that according to the opinion of authorities consulted "there seemed to be no change in the business during the past year" and the report indicates a net worth of from $10,000 to $15,000.

(f) It further appears from the testimony of the witness Blodgett that it was his opinion at the time that he was negotiating with the bankrupt regarding remaining in business, that the property of the bankrupt might be sold for a sufficient sum to pay all his obligations. The testimony of the witness on this point is as follows:

> "Mr. Schwan and Mr. Swanholm of our company came to San Diego and together we discussed the situation pretty thoroughly because we were even trying to work out a plan whereby Mr. Lessar could be brought into the breach with guaranty, or with money, or with a lease on the property that would allow them to sell their equipment and stock, together with the lease, for a sufficient amount to take them out of the hole." [Tr. of Rec. p. 40.]

It appears from this testimony that the witness at the time in question thought there was a possibility of making such arrangements as would permit the property to be sold for sufficient to pay the bankrupt's debts, as his statement about taking them "out of the hole" can have no other meaning. Again we insist that this statement of the witness contradicts and refutes his testimony to the effect that the bankrupt was insolvent at all times after January 1, 1928.

The foregoing summary is all of the evidence we can point to in the record which tends in any way to prove the very essential fact that the bankrupt was insolvent.

Thus we see that the only testimony tending to prove insolvency is the statement by Mr. Schwan that he knew the bankrupt was "broke"; the statement by Mr. Blodgett that he told Mr. Schwan that his company had put Gordon on a cash basis; the conclusion of Blodgett that the bankrupt was insolvent together with the opinion of the same witness that some of his accounts receivable were uncollectable and he was unable to pay his obligations when due, and that bankrupt had no lease. Over against the foregoing evidence we have the following facts which are uncontradicted and most of which were furnished by appellee's own witness, tending to prove solvency: Finan-

cial statement prepared by Blodgett, Schwan and Mrs. Gordon [Tr. of Rec. pp. 34-36] after an inventory and appraisal of the property, showing a net worth of nearly $5,000; Mr. Blodgett says Gordon gave him a statement in January, 1928, showing a net worth of $17,000; statement made by Blodgett to his company in which he assured his company that their account would be collected in full; and the testimony of Blodgett that he was trying to arrange matters so that the property could be sold for enough to "take them out of the hole," and Bradstreet's statement showing a net worth of from $10,000 to $15,000.

BURDEN OF PROOF.

The burden was upon the trustee to prove insolvency at the time of the transfer.

Remington on Bankruptcy, Vol. 1, Secs. 182, 188; Vol. 4, p. 639.

This is true since the adjudication creates no presumption as to insolvency on any date prior to the date of adjudication.

In re Star Spring Bed Co. (C. C. A.), 265 Fed. 133;

In re Chappell, 113 Fed. 545;

Remington on Bankruptcy, Sec. 1764.

In the case *In re* Chappell, *supra*, the court points out that an adjudication isn't even evidence of insolvency at the time of the filing of the petition, for the reason that a solvent person may file a petition in bankruptcy and be adjudicated. As to the adjudication being evidence of insolvency at any date prior to the adjudication, the court says (p. 547):

"Let us, however, for argument's sake, assume that the adjudication established the fact of insolvency on the 8th of November, the date of the filing of the bankrupt's petition and of the adjudication. This fact alone, whilst consistent with, did not show insolvency at a previous date. In the case *In re* Rome Planing Mill (D. C.), 96 Fed. 812, a proceeding in involuntary bankruptcy wherein the petition was filed on the 8th of November, 1898, and the controversy was whether or not certain judgments against the bankrupt corporation obtained on the 17th of October, 1898, were suffered or permitted by the debtor while insolvent, District Court Judge Coxe of the Northern District of New York said:

" 'As before stated, it is necessary for the petitioners to prove the judgments, the levy, the sale and the insolvency on Oct. 17, 1898, the date of the judgments. The referee finds all these facts except the insolvency. The finding that the company was insolvent Nov. 1st does not meet the requirements of the statute. The company might have been solvent on Oct. 17th and hopelessly insolvent two weeks later.' "

We insist that the appellant has not sustained the burden which the law thus imposes upon him, as there is no testimony whatever as to the value of the assets or the amount of the liabilities except what is contained in the two financial statements herein referred to. Since it is the rule that insolvency must be proved as any other fact is proved, the only competent proof of insolvency would be proof as to what the nature and extent of the debtor's property is, together with testimony of its fair valuation and testimony as to the extent of his liabilities. Such testimony would bring the proof within the provision of subdivision 15 of section 1, Bankruptcy Act, defining insolvency. On this proposition appellant cites:

Jump, as trustee, etc. v. Burnier (Mass.), 108 N. E. 1027;

Schloss v. Strefellow & Co., C. C. A. 3rd Ct., 156 Fed. 662.

The case of Jump v. Burnier, *supra,* was a suit by a trustee in bankruptcy to set aside a preference, the suit having been brought in the state court of Massachusetts. In commenting upon the kind of proof which had been relied upon to prove insolvency, the court said:

> "The testimony offered to show the value of the assets and the amount of the debts could not designedly have been more vague, indefinite and unsatisfactory. It does appear that there were three parcels of real estate, in the city of Cambridge, but no evidence was produced or offered to show the fair value of any single parcel or of all of the parcels, nor was there any testimony of market value, assuming that in a supposable case there may be a difference in those terms of measure of value. The evidence showed that the first of the three parcels was let out at a gross weekly rental of $35.00, and the third, a double house, was occupied by Burns, his son, with no stated rental value. No testimony appears to have been given of the fair or market value of any personal property. It would be possible to estimate the annual rental value of the two rent producing parcels, but no data exists upon which an opinion can rest of the market or rental value of the third parcel.
>
> "Even if it were possible to determine by estimate the rental value of these properties, the fair or market value remains an unanswered speculative question. So long as this question remains unanswered it is impossible to say that Burns was insolvent when he gave the assignment to Burnier. As to the debts, the son testified:
>
> " 'Well, I don't know; the schedule in bankruptcy will show that. I think $25,000.'

> "Again: 'I couldn't state the exact amount. I should estimate 25,000; I don't know whether I am 10,000 out or not.'
>
> "The precise question was whether the property of Burns at a 'fair valuation' would be sufficient to pay his debts, and for the solution of that question it would be quite as needful to ascertain with some degree of precision the amount of his debts as the value of his property."

Th case of Schloss v. Strefellow & Co., *supra,* was an involuntary bankruptcy proceeding and the issue was whether the alleged bankrupt had committed an act of bankruptcy while he was insolvent. Before the trial the court had made certain orders by which certain claims of creditors had been established together with the amount thereof. These orders were relied on at the trial as proving conclusively the fact of insolvency. No other testimony as to the amount of indebtedness was offered. In holding that this was not sufficient proof to enable the court to pass upon the question of insolvency, the court said (pp. 663-664):

> "The precise question as defined by the Bankruptcy Act was whether the property of Schloss would, at a fair value, be sufficient in amount to pay his debts and for the solution of that question it was quite as needful to ascertain the amount of his debts as the value of his property. These elements were both inherent in the question of his insolvency."

In the case at bar there was not only no competent proof as to the nature and value of the bankrupt's property, but there was no proof whatever as to the extent of his liabilities except the proof that was contained in the two property statements to which we have referred, and both those property statements show solvency. If by the term insol-

vency were meant inability to pay debts as they mature, it might be conceded that there is some evidence to show that the bankrupt was in such condition. But we confidently urge that there is no proof of insolvency as that term is defined by subdivision 15, section 1 of the Bankruptcy Act.

Assignment of Error Number Two. [Tr. of Rec. p. 45.]

REASONABLE CAUSE TO BELIEVE THE TRANSACTIONS WOULD EFFECT A PREFERENCE.

The burden is not only on the trustee to prove that the bankrupt was insolvent at the time of the transaction in question but he must prove further that the creditor had reasonable cause to believe that a preference would be effected as a result of the transaction.

Remington on Bankruptcy, Sec. 1829.

SUMMARY OF TESTIMONY AS TO REASONABLE CAUSE TO BELIEVE A PREFERENCE WOULD BE EFFECTED.

We propose to summarize the testimony that was before the court on the question of whether the appellant had reasonable cause to believe that a preference would be effected by the return of the merchandise in question.

(a) At page 21, transcript of record, appears a letter dated April 4th, 1928, written by the manager of the India Tire & Rubber Co. to the manager of the Richfield Oil Co. at San Diego in which it appears that the India Tire & Rubber Co. was counting upon Gordon remaining in business and apparently had no thought of the business being closed. It appears from this letter that the manager of the India Tire & Rubber Co. was willing to assist the

Gordons to procure a good salesman to handle the business. Apparently the manager realized that on account of Mr. Gordon's illness the business was not being properly cared for and that a salesman was needed to put the business in the condition that it should be in.

(b) At page 22, transcript of record, the witness Blodgett states:

> "After the conversation of May 8th, I attempted to work out a scheme to relieve him in his financial condition and I took up that question with Mr. Schwan of the India Tire & Rubber Co."

After that conversation between Blodgett and Schwan the letter of May 17th, appearing at page 22, transcript of record, was written setting out a copy of a telegram which Mr. Schwan, of the India Tire & Rubber Co., had sent to his factory. This telegram and a reply thereto which appears at page 23, transcript of record, show that the appellant and the Richfield Oil Co. were working together as late as May 17, 1928, which was thirty days after the tires were returned, to keep the Gordons in business and that neither concern was expecting bankruptcy or a closing of the business. If the business continued there would be no occasion for a preference on the part of any creditor. It would be only in case of the failure of the business that a preference would occur and these telegrams show that as late as May 17th both of these principal creditors were expecting the business to continue and to pay out.

(c) At page 25, transcript of record, is further evidence of the efforts of Blodgett and Schwan to keep the business going and further evidence that they expected that the business would be kept going. These men were

then talking about getting an additional salesman for the Gordon business. Here the witness Blodgett states that he and Mr. Schwan were endeavoring to get somebody to refinance Mr. Gordon so that he could get out of the period of depression and "bring ourselves out of the woods." These men were at this time looking to the future and to the success of the business and not to its failure or to the necessity of bankruptcy.

(d) Again at page 26, transcript of record, it appears that Gordon and Schwan were enlisting the aid of Mr. Lessar to make possible a continuation of the business. Again at pages 37-38, transcript of record, it appears that Mr. Blodgett had reported to his company that Gordon's account would be paid in full. The letter of the credit manager of the Richfield Oil Co. to Mr. Blodgett, set out at the pages last mentioned, states:

> "Your assurance of the ultimate collection in this instance has made us feel easier about the situation and we certainly appreciate the efforts you are making to protect us on the balance outstanding."

Here we have evidence that about the 12th of March, 1928, Mr. Blodgett, who now attempts so earnestly to show that Gordon was at all times insolvent, was assuring his own company of the ultimate collection of their claim against Gordon. Presumably his assurance to his own company was given in good faith and presumably Blodgett had reason then to think that Gordon would not fail in his efforts to put the business "out of the woods." All through Mr. Blodgett's testimony he tries to make it clear that he and Mr. Schwan were working together and conferring together about Gordon's affairs. If Mr. Blodgett was sanguine enough of success so that he could give his

company assurance of the collection of their account in full, it is not unreasonable to think that Mr. Schwan was as hopeful of the success as Mr. Blodgett seemed to be. In fact, Mr. Blodgett [Tr. of Rec. p. 38] at the time this letter was written (referring to the letter to him of March 12th) stated, "I had told Mr. Schwan about the conditions out there at Gordon's." If they were as hopeful of success as they seemed to be, there was no reason for Mr. Schwan to anticipate that the business would fail, and if the business did not fail there would be no reason to think that the return of the tires in question would result in a preference in favor of the appellant.

(e) If any doubt remains as to Mr. Schwan's thought regarding the success of the efforts of himself and Mr. Blodgett to save the business of Mr. Gordon, that doubt is dispelled by the statement of Mr. Blodgett [Tr. of Rec. p. 39] as follows:

> "Mr. Schwan was of the opinion that he and I, working together, would avoid a calamity in this matter."

(f) The evidence shows [Tr. of Rec. p. 27] that before appellant accepted a return of the merchandise in question Mr. Schwan took precaution to inform himself as to the debtor's financial condition. He called upon Bradstreet & Co. for a financial report. The testimony shows that this report was forwarded to the appellant on March 21, 1928, and in that report the bankrupt was given a net credit rating of from $10,000 to $20,000. We contend that this is evidence of the utmost of good faith on the part of appellant. Presumably Mr. Schwan knew that Mr. Gordon was having financial difficulty at the time that this inquiry was made but he apparently preferred to call

upon a substantial and responsible commercial agency for definite information rather than to rely upon the uncertain information and rumors which he already had. In response to his request, the report was given in due course. Mr. Schwan was presumably acquainted with what Mr. Gordon's financial condition had been in the past and when he received the financial report in which Bradstreet & Co. had stated that there "had been practically no change in the business during the past year" it is but natural that Mr. Schwan would have concluded that Gordon was solvent. It would be most unnatural for Mr. Schwan to have called on Bradstreet & Co. for this report and, after having received it, come to a conclusion that Gordon was insolvent, in the face of the showing made by this report.

(g) It appears from the testimony that the reclaiming of these tires on April 18th, 1928, was not an unusual circumstance in the relations of the appellant and the bankrupt and other tire dealers. At transcript of record, page 30, it appears that in October, 1927, $4,500 worth of merchandise had been returned to appellant by Gordon and at page 33, transcript of record, it appears that the same practice prevailed in appellant's dealings with other customers.

(h) In the testimony of the witness Storms [Tr. of Rec. pp. 30-33] the witness gives in detail his conversation with Mrs. Gordon, who was in charge of the business at that time he took the tires from Gordon's place of business on April 18th. Among other things the witness says that Mrs. Gordon agreed that this was the proper thing to do; that Mrs. Gordon was very optimistic of the success of the business in the future; that they would be

able to carry on the business and pay out all they owed in a short time. Now if Mrs. Gordon did not give this assurance to the witness Storms on the occasion in question, it is fair to assume that she would have been called as a witness in behalf of the trustee in this proceeding to contradict and refute the testimony of Storms as to what she said on that occasion but no such testimony was given and neither Mr. nor Mrs. Gordon was called to testify in behalf of the trustee. If Mrs. Gordon did make the statements to Mr. Storms to which Mr. Storms testified, it is the most convincing evidence of the faith of these people in the success of their efforts to keep this business going and to "avoid a calamity" and of the fact that both Storms and Schwan shared that faith. The testimony of the witness Storms further shows that the reason they took a return of the merchandise was that they felt that Mr. Gordon was overstocked and that the company needed the merchandise to supply its trade. The witness states that he told Mrs. Gordon that this was the reason they wanted the merchandise returned. Again, if this were not true, we say that the objecting trustee would certainly have called Mrs. Gordon to furnish the necessary refutation. But if it is true that the reason the appellant reclaimed the tires was because Gordon was very sick and was overstocked and appellant needed the tires for its trade, and further, if it is true that at the time this was done both the Gordons and the appellant expected and believed that the business of the bankrupt was to be kept going, there is no support for the finding of the Referee that the appellant had reasonable cause to believe that a preference would be effected by the return of this merchandise.

(i) Further evidence of the faith of the appellant in the success of Gordon's business is found in the fact that from January, 1928, to the time the goods were returned, appellant had sold Gordon $6,500 worth of merchandise on credit. [Tr. of Rec. p. 32.]

WHAT CONSTITUTES REASONABLE CAUSE TO BELIEVE THAT A PREFERENCE WOULD BE EFFECTED?

On this proposition we cite:

McLaughlin v. Fiske Rubber Co., 288 Fed. 72;

Studley v. Boylston Bank, 229 U. S. 523, 52 L. Ed. 1313;

In re Wright-Dana Hardware Co., 203 Fed. 297;

Gilbert's Collier on Bankruptcy, pp. 852, 848-849;

Grant v. National Bank, 97 U. S. 80, 24 L. Ed. 971.

The rule is thus stated in Gilbert's Collier on Bankruptcy, page 852:

> "The fact that most of the bankrupt's indebtedness to a creditor was past due at the time of a payment on account is not sufficient to charge a creditor with notice of the bankrupt's insolvency; neither is the fact that a firm is unable to meet all its obligations as they fall due alone sufficient to cause a reasonable belief that he is insolvent."

Again at page 848 the same author says:

> "If the bankrupt was concededly unbusinesslike and slovenly in his business transactions, a failure to maintain his credit by prompt payments and a shortness of cash and absence of free capital continuing for a long time without insolvency, are not of themselves enough to put on inquiry all who deal with him."

Cause to suspect insolvency is not synonymous with reasonable cause to believe that the debtor is insolvent.

Grant v. National Bank, *supra,* was a case brought by a trustee in bankruptcy to set aside a mortgage executed by the bankrupt within four months prior to bankruptcy. In the opinion Mr. Justice Bradley states the rule thus:

> "It is not enough that the creditor has some cause to suspect the insolvency of his debtor; but he must have such knowledge of facts as to induce a reasonable belief of his debtor's insolvency in order to invalidate a security taken for his debt. To make mere suspicion a ground of nullity in such a case would render the business transactions of a community altogether too insecure. A man may have many grounds of suspicion that his debtor is in failing circumstances and yet have no cause for well grounded belief of the fact. He may be unwilling to trust him further, he may feel anxious about his claim and have a strong desire to secure it, and yet such belief as the act requires may be wanting."

McLaughlin v. Fiske Rubber Co., *supra,* is a case very similar indeed to the case at bar. The bankrupt had been purchasing tires of the defendant tire company and one of the salesmen of said company called at the bankrupt's place of business and demanded payment of the amount due. The bankrupt stated that he was overloaded with tires and did not have the money to pay. The salesman made another call with the same results. Thereupon the salesman suggested that the bankrupt return the goods, or a portion of them, and take credit at the price at which the goods had been charged to him. To this arrangement the bankrupt consented. It later appeared that the bankrupt was insolvent at the time of this transaction but except that Reed, the salesman, knew that the bankrupt was over-

stocked and was unable to meet his obligations in cash, the tire company had no knowledge or reason to believe that the bankrupt was at that time insolvent. In holding that this transaction did not amount to a voidable preference the court said:

> "It can hardly be said that the bankrupt's inability to pay in cash as the payments for the tires became due would necessarily lead a reasonably prudent man to conclude that bankrupt was insolvent or would be unable to pay his debts in the usual course of business. Especially is this true in view of bankrupt's statement, which appeared to be trustworthy, that he was carrying a surplus stock. I do not find that the defendant knew or had reasonable cause to believe that a preference was intended or would be effected by taking over the tires and selling them at an advanced price."

Mere Knowledge of Insolvency Not Sufficient.

Studley v. Boylston Bank, *supra*, is authority for the proposition that knowledge of insolvency on the part of the creditor will not alone be sufficient to avoid a payment made by the debtor to a creditor. In that case the defendant bank had extended credit from time to time to the Collver Company, the bankrupt. After the bankrupt had thus become indebted in a large amount to the bank, the officers of Collver Company showed the officers of the bank a statement which showed that the company did not have assets sufficient to pay its liabilities. Notwithstanding the knowledge of this situation, the bank made additional loans to the bankrupt and accepted payments from time to time to apply on account, but made the loans with the belief that notwithstanding the insolvency of the Collver Company it would succeed in working itself out of its financial

difficulty and the bank believed, therefore, that no preference would result from the payments it accepted from time to time.

From the opinion by Mr. Justice Lamar we quote (p. 526):

> "There is nothing in the statute which deprives a bank, with whom an insolvent is doing business, of the rights of any other creditor taking money without reasonable cause to believe that a preference will result from the payment. The Bankruptcy Act contemplates that by remaining in business and at work an insolvent may become able to pay off his debts. It does not prevent him from continuing in trade, depositing money in a bank, drawing checks and paying debts as they mature, either to his own bank or any other creditor. It does provide, however, that if bankruptcy ensues all payments thus made within the four-month period may be recovered by the trustee if the creditor had reasonable cause to believe that a preference would be thereby effected."

Here we find a clear distinction expressed between mere knowledge of insolvency and reasonable cause to believe that a preference would result from a payment made or from property taken by a creditor.

In the Studley case there appears to be no question that the bank's officers knew that the debtor was insolvent at the time the payments in question were made but they knew business was being obtained by the bankrupt, knew deposits were made, and it appears that all concerned believed that the business would finally be a success. As long as the creditor believed such to be the case there is no room to contend that he had reasonable cause to think that a preference would result from his transaction with the debtor. Reasonable cause to believe that a preference will

result cannot exist as long as there exists a reasonable expectation that a business will succeed.

In the case at bar we have pointed out from the evidence the facts which we believe indicate beyond peradventure of doubt that not only Mr. Schwan and the others connected with the India Tire & Rubber Co., but Mr. Blodgett and the other creditors all confidently expected the business of the bankrupt to ultimately pay out. Ample evidence of this fact is found in the financial statement prepared by Mr. Blodgett and Mr. Schwan, with the assistance of Mrs. Gordon, after an inventory and appraisal of the stock had been made on May 8th, 1928. These men, after a careful survey of the situation, prepared a statement which showed a net credit balance of nearly $5,000 and Mr. Blodgett was so sure that this statement was a fair reflection of the financial condition of the bankrupt that he sent it to his company and continued thereafter, in co-operation with Mr. Schwan, his efforts to place the business on a paying basis.

The same rule as is found in Studley v. Boylston Bank is also announced in the matter of Wright-Dana Hardware Co., *supra*. This is a case from the Circuit Court of Appeals, Second Circuit. From the opinion we quote:

> "Our attention is called to the fact that the referee found that the Wright-Dana Company was insolvent on Sept. 15, 1911 (four months before bankruptcy), and continued to be insolvent to the date of its adjudication in bankruptcy on Feb. 5th, 1912, and that during the whole of that time the fact of its insolvency was known to the bank. All this may be true and yet not deprive the bank of its right to set-off. A bank may do business in the usual manner with one it knows to be insolvent. The mere fact of insolvency or mere knowledge of the insolvency of the depositor

is not alone sufficient to take away the bank's right of set-off."

The writer of the opinion then quotes with approval from Studley v. Boylston National Bank to the effect that it is belief that a preference would be effected by the transaction and not knowledge of insolvency which determines the validity of a transaction with an insolvent debtor.

Not only is it true that it is the policy of law, and of the Bankruptcy Act in particular, to permit debtors who are in financial difficulties to continue in business rather than to be forced into bankruptcy but it is also the policy of the law that where two inferences may be drawn from the facts proved, that inference will prevail which will sustain a transfer rather than invalidate it. The rule is so stated in Gilbert's Collier, page 64, and *In re* Gaylord, 225 Fed. 234.

Conclusion.

In conclusion we call attention to the fact that no findings were made by the District Court. Findings were made by the Referee to the effect that the debtor was insolvent at the time of the return of the merchandise in question and to the further effect that the appellant had reasonable cause to believe that the bankrupt was insolvent and that the transfer would effect a preference. Notwithstanding this finding, it is our contention that this court may determine for itself the questions of fact thus presented:

1. For the reason that there is no conflicting testimony, and

2. Because this is an equity proceeding and the court may examine the entire record.

On the first proposition just referred to we quote Gilbert's Collier on Bankruptcy, page 571, as follows:

> "A referee's finding concurred in by the District Court that a creditor received a payment from a debtor who had reasonable cause to believe that a preference would be effected will not be set aside on appeal on anything less than a demonstration of plain mistake. But if the finding of the district judge be a deduction from established facts or uncontradicted evidence, the Circuit Court of Appeals is at liberty to draw its inference and deduce its own conclusions."

On the second proposition just referred to we cite *In re* Gregg (C. C. A., 8th Cir.), 9 Fed. (2nd) 43, and from the opinion in this case we quote:

> "The referee found that the bankrupt was solvent at the time of the levy. The trial court expressly declined to rule upon the question of insolvency, sustaining the referee upon other questions which we have not discussed. Appellant contends that this court must accept the finding of the referee as to solvency. This is an equitable proceeding and we may examine the entire record. Nor are we faced with the situation that the finding of the referee is affirmed by the trial court. We entertain no doubt of our right and duty to examine the record and determine this matter of fact therefrom."

For all the foregoing reasons we ask that the decision of the District Court be reversed.

Respectfully submitted,

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